

MONDAY TUESDAY WEDNESDAY THURSDAY **TODAY**[Previous](#) [Next](#)[Bookmark](#) [Reprints](#)[Questions and Comments](#)[NEWS](#) [RULINGS](#) [VERDICTS](#)

Friday, August 3, 2012

## Life insurance: the powerful and despised tax shelter

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A perfect tax shelter would have five features: deductible contributions; tax free accumulations; tax free distributions; assets not included in the owner's taxable estate; and a tax opinion from a prestigious law firm or, better yet, an approval letter from the IRS National Office.

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Most tax advisors consider pension plans to be the closest thing to a perfect modern tax shelter because pensions have three of the five features: deductible contributions; tax free accumulations; and the IRS National Office will issue a favorable determination for each employer's plan. Pensions lack

tax free distributions and assets are included in the participant's taxable estate. Partly offsetting the shortcomings is a major non-tax benefit: pension trust assets are protected from all but three creditors ("super-creditors"): the U.S. government; spousal support orders; and child support orders.

In some situations pensions do not make sense. Assume Joe, the sole shareholder of a corporation, is 45, earns \$200,000 as an employee and wants to contribute \$100,000 to a pension. However, he has 9 employees, each of whom is 55 and earns \$200,000. No matter how skilled the tax lawyer and actuary Joe hires, only a small percentage of the contributions would accrue to Joe's benefit. Joe would be economically better off paying tax on the \$100,000 and pocketing the balance.

In other situations, pensions are unavailable. Assume Sam owns investment real estate. He nets \$300,000, needs \$200,000 to live on and would like to contribute \$100,000 to a pension. Since Sam has no active business to sponsor the plan, and no compensation upon which a pension formula can be based, a pension is unavailable.

There is a financial product that that is seldom discussed as a tax shelter. However, it also has three of the five features, and one that it lacks seems irrelevant. Unfortunately, this product is despised. Therefore, we try not to discuss it by name. It is like Voldemort from "Harry Potter": The Tax Shelter-Which-Must-Not-Be-Named.

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**Life insurance policies have tax free accumulations, tax free distributions and estate tax exclusions, which easily make up for the lack of deductions [that are available in pension plans].**

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Unlike pension plans, contributions are not deductible. However, funds accumulate tax free. Distributions can be tax free. Assets can be outside the participant's taxable estate. The structure's tax bona fides are such that no one would seek a lawyer's opinion letter. The IRS National Office might issue a Private Letter Ruling. However, most advisors would view that as a waste of the user fee charged by the IRS.

Since this financial product has been so blessed by Congress, it is the duty of tax lawyers to explain the benefits. First, Internal Revenue Code Section 264 prevents deductions for premiums paid on life insurance policies and loans used to buy policies. Second, IRC Sections 801 et seq. provide for the tax free "inside buildup" for insurance

### Law Practice

#### Justice Department opposes undocumented immigrant's admission to State Bar

In an amicus brief submitted early Thursday, the U.S. Department of Justice argued that the state Supreme Court may not legally admit an undocumented immigrant to the State Bar.

### Intellectual Property

#### Oracle takes \$306 million award from SAP in copyright case

Oracle Corp. agreed Thursday to accept a \$306 million damage award from German rival SAP AG, ending the trial court phase of the massive copyright infringement litigation.

### Apple sanctions motion in Samsung case poses early test for judge

In an early test for U.S. District Judge Lucy H. Koh, an attorney for Apple Inc. asked her Thursday to punish Samsung Electronics Co. Ltd. for releasing a statement about excluded evidence by ruling its design patent claims are infringing.

### Judges and Judiciary

#### Two prospective federal judges approved by Senate committee

Tigar, Orrick bids to become federal judges clear Senate committee

### Solo and Small Firms

#### Firm strives to block publicity for high profile clients

Despite their propensity to represent prestigious people, there's one thing lawyers at Beverly Hills-based Jaffe & Clemens won't do: Talk about their clients.

### Criminal

#### U.S. attorney accused of improperly threatening pot prosecutions

The American Civil Liberties Union is accusing U.S. Attorney Laura Duffy of trying to improperly sway Del Mar voters deciding a medical marijuana measure by implying that city employees could be criminally liable for issuing pot permits.

### Legal Ethics & Professional Responsibility

#### Robbins Geller attorney resigns after reproval

Following a July 24 reproval from U.S. District Judge Justin L. Quackenbush in Washington, Joy A. Bull resigned from Robbins Geller Rudman & Dowd last week. The judge also sanctioned John K. Grant, who remains at the firm.

### U.S. Court of Appeals for the 9th Circuit Defense contractors can be held liable for lowballing bids, 9th Circuit panel rules

Cracking down on government contract fraud, a 9th U.S. Circuit Court of Appeals panel on Thursday held for the first time that contractors can be held liable for deliberately lowballing bids to get jobs, then jacking up prices.

### Judges and Judiciary

#### OC court scales back services

policies. Third, Section 72(e)(5)(A) authorizes tax-free borrowing from a policy if the loan does not exceed the investment in the contract. Also, Section 101 excludes from gross income amounts received as a death benefit. Fourth, IRC Section 2042 provides the rules for excluding the proceeds from the insured's taxable estate, e.g., having the insurance policy owned by an irrevocable trust. Note: having the policy owned by an irrevocable trust also provides the same non-tax benefit as a pension: creditor protection, and no exceptions for the three super-creditors. Finally, these rules are so familiar and so plain from the face of the Internal Revenue Code that a lawyer's opinion letter should be unnecessary for a taxpayer's comfort, and few advisors would recommend spending the time and money on a request to the IRS National Office.

Let us return to Joe, the sole-shareholder of the closely held business who has so many employees that a pension plan is uneconomical. Instead, Joe establishes an irrevocable trust for the benefit of his spouse and children and has the trust buy a life insurance policy using the same \$100,000. Because the \$100,000 is not deductible, Joe has only \$55,000 (assuming a combined 45 percent state and Federal income tax rate) to give to the trust, which the trust uses to pay as a premium. At the end of 10 years Joe will have given, and the trust will have paid, \$550,000.

Depending upon many factors, e.g., the insurance company; the particular product; and Joe's health, the policy is likely to have close to \$550,000 in cash surrender value. Joe will only be 55, not ready for retirement. So he will allow the policy to continue accumulating until he is 70, the same age at which he would normally start taking pension distributions. If he dies, of course, the policy pays off - income tax free - to the trust, for the benefit of his spouse and children. Otherwise, starting at age 70 the trustee of the insurance trust borrows money each year from the insurance company secured by the policy and, in turn, loans money to Joe. These loans are tax free to Joe. He must pay interest. However, the interest can be covered by the next year's loan. The trustee can borrow from the policy, and Joe can borrow from the trust, enough of the policy to provide an extraordinary retirement "income" to Joe while keeping the policy in force until Joe's death.

How do the two tax shelters compare? Assuming the same \$100,000 going into each, the same earnings rate and the same taxation rate on earnings and distributions, they will be roughly the same in terms of the dollars distributed to the participant/owner at the end. Of course, figures don't lie, and liars use figures, so you will see presentations cogently arguing in favor of one over the other. Pension plans have the deductible contribution, which is the sizzle. However, life insurance policies have tax free accumulations, tax free distributions and estate tax exclusions, which easily make up for the lack of deductions. So life insurance policies are a powerful, overlooked, misunderstood and - improperly - despised tax shelter that more people should be enthusiastically adopt.


[Previous](#)   [Next](#)

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EVERY SATURDAY AND SUNDAY ON THE FOLLOWING STATIONS:

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*Hosted by:*  
**THOMAS V. GIRARDI**

**Listen to the  
Finest Legal Minds  
in California  
Talk about the Law**

In an ongoing effort to pare back services, Orange County Superior Court announced earlier this week that it will soon cease hearing small claims and civil suits filed at its West Justice Center in Westminster.

#### Alternative Dispute Resolution

##### Kevin T. McIvers

Being tuned in to the emotions of a case is one of the important challenges of mediation that neutral Kevin T. McIvers faces.

#### California Courts of Appeal

##### Appellate panel upholds same-sex partner's parental rights

A woman who helped raise the adopted child of her former same-sex partner has parental rights to the child, the 4th District Court of Appeal ruled Thursday.

#### Entertainment & Sports

##### Subjectivity in Olympic judging

The closer rule making respects this basic, underlying structure, the greater the related event's integrity. By **Robert L. Bastian Jr.** of the Law Offices of Bastian & Dini

#### Tax

##### Life insurance: the powerful and despised tax shelter

Life insurance policies have many benefits that easily make up for deductible contributions available in pension plans. By **Bruce Givner** and **Owen Kaye** of Givner & Kaye

#### Foreign accounts and the Offshore Voluntary Disclosure Program

To date, the IRS has collected more than \$5 billion in back taxes, interest and penalties from 33,000 voluntary disclosures made under the 2009 and 2011 programs. By **Brad Martinson** of Rutan & Tucker LLP

#### Entertainment & Sports

##### 'Modern Family' cast invokes 'seven-year rule'

The cast is lucky to avoid judicial review, since Section 2855(a) only voids the term of services agreements "beyond seven years from the commencement of service under it." By **David B. Stern** of Jeffer Mangels Butler & Mitchell LLP

#### Bar Associations

##### Proposed financial regulation stirs ABA worries

A proposed federal regulation requiring reports from financial institutions on their reserves for pending litigation claims has drawn a concerned letter from the American Bar Association over attorney-client privilege issues.

#### Judicial Profile

##### Mary Thornton House

Mary Thornton House Los Angeles County Superior Court (Pasadena)

#### Entertainment & Sports

##### Rolling the dice on online gambling

As efforts to legalize Internet gambling slowly gather momentum, video game developers and investors are consulting lawyers on how to get in position to capture a potentially explosive market while staying on the right side of the law.